From: POGO [pogo@pogo.org]

Sent: Monday, November 10, 2003 2:20 PM

To: MRM Comments; Gebhardt, Sharron

Subject: Attn: "Federal Oil Valuation Proposed Rule Comment"

November 10, 2003

Sharron Gebhardt, Regulatory Specialist
Minerals Management Service
Minerals Revenue Management
Building 85, Room A-614
Denver Federal Center
Denver, Colorado 80225

Re: Comments on Federal Oil Valuation Proposed Rule (68 Fed. Reg. 50087)

POGO OPPOSES THE PROPOSED CHANGES TO THE OIL VALUATION RULE

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Dear Ms. Gebhardt,

The Project On Government Oversight (POGO) has worked for over a decade to make federal oil royalty payments more accurate and transparent. The oil valuation rule, as implemented in 2000, went a long way to combat the rampant fraud perpetrated by the oil industry and allowed by a complacent Department of Interior. There is no justification for the currently proposed changes other than to accede to industry's wishes to reduce royalty payments to taxpayers.

Oil Rule: "Technical Changes" or Capitulation to Industry's Wish List

MMS's proposed "technical" changes to the oil valuation rule were the product of secret negotiations between the oil industry and high level officials of the Department of the Interior in 2002. The meetings were held to "settle" litigation filed against the oil valuation rule by the two largest oil industry associations, the American Petroleum Institute (API) and the Independent Producers Association of America (IPAA). These meetings took place after court decisions in a related case that established that industry would lose its primary challenge to the oil valuation rule. But instead of declaring victory, MMS decided to throw in the towel.

The current oil valuation rule became effective in June 2000 after five years of public notice and comment rulemaking. MMS estimated that the taxpayer would gain $72 million per year in additional royalties owed mostly by major oil companies. The rulemaking coincided with litigation instituted by the Clinton Administration Justice Department, which exposed major oil company bad faith and fraudulent underpayment of royalties owed during prior years. The federal government recovered over $425 million in settlements of that litigation.

Shortly after the U.S. Court of Appeals for the District of Columbia issued a decision favorable to Interior's position in a related case involving gas valuation, the new MMS Director, appointed by the Bush Administration, and vowed that she would re-evaluate the Clinton rule

Industry asked the Court of Appeals to rehear its case on the gas rule, but not a single judge on the entire court voted to revisit its decision in favor of Interior. Nonetheless, industry asked the Supreme Court for review in September 2002. That same month API and IPAA began settlement discussions on the oil valuation rule case, negotiations that lasted at least through December 2002.

One month after the Supreme Court refused industry's certiorari request (January 13, 2003), MMS published a "Notice" that it would hold workshops to discuss "technical" changes to the oil valuation rule, which it said were based on its "experience" with the 2000 oil valuation rules. 68 Fed. Reg. 7086 (February 12, 2003). MMS did not disclose its meetings with API and IPAA or the relationship of its proposed "technical" changes to the litigation over the oil valuation rules. Instead, it listed five topics for discussion at the workshops, all of which were lifted from filings made by API and IPAA in their lawsuit. The public was told to focus on those five issues – any other matters could be raised only if time permitted. The Notice said nothing about a future notice and comment rulemaking. Technical amendments to agency rules do not have to be promulgated through notice and comment rulemaking.

In a February 26, 2003 Status Report to the Court, oil industry representatives wrote:

> "The Department of the Interior ("Department") has recently announced it is conducting workshops to gather additional information on the oil valuation rule at issue in this case. 68 Fed. Reg. 7086 (February 12, 2003). These workshops could lead to the initiation of a rulemaking. Plaintiffs believe that the rulemaking being considered by the Department has the potential for resolving some or all of the issues before this Court in this case. If the Department does initiate such a rulemaking, Plaintiffs contemplate filing with this Court a motion to hold this case in abeyance pending completion of the rulemaking with a commitment to give the Court quarterly status reports."

On March 17, 2003, the Court issued an Order stating:

> "This case comes before the Court on Plaintiff's [oil industry's] status report of February 26, 2003, notifying the Court that a rulemaking under consideration by the Department of the Interior may resolve some or all of the issues before the Court in this case. The Plaintiff [oil industry] further informs the Court that the parties will know on or about May 1, 2003, whether the rulemaking will go forward."

At the Workshop held in DC on March 6, 2003, POGO, along with other public participants, challenged MMS's characterization of its proposals as "technical" amendments. The Associate Director, MMS, conceded that a proposal would have to be published for notice and comment.

Shortly after Congress recessed, on August 20, 2003, MMS published a proposed rule for public comment, which again largely adopts industry's outline and characterizes them as "technical" amendments. MMS set a short 30 day comment period, and indicated that it expected to publish a final rule by October. It did not address any of the negative comments it received from states and tribes during the workshops. It did not make POGO's written workshop comments publicly available.

The comment period was extended as a result of congressional pressure directed at MMS's failure to provide any data supporting its assertion that its "experience" under the 2000 oil rules supported its proposed changes. It has yet to produce any independent, reliable data that even suggests that its findings underlying the 2000 federal oil rule are erroneous, ineffective or inefficient. Instead, MMS is trying to ameliorate the oil industry's judicial losses through a rulemaking that will increase deductions from the public's royalty share.

Finally, on October 31, MMS Director Johnnie Burton dismissed Congressional requests for explanations behind this proposed rule, using the bizarre logic that their questions couldn't be answered <u>because</u> it was during a public comment period! How then, did MMS expect Members of Congress to participate in the public comment period if even the most basic questions about the need for this proposed rule could not be answered by Interior?

Perhaps even more disturbing, is that this assault on the oil valuation rule comes at a time when MMS is aggressively engaging in the implementation and expansion of two other initiatives – which unlike the 2000 oil rules actually don't work, but which do benefit the oil industry at the public's expense.

MMS Audit Systems Being Dismantled

MMS doesn't know whether the current oil valuation rule is adequately collecting royalties or not for two very simple reasons: first, it is not actively auditing federal lessees, and second, its new "re-engineered" computer compliance system is a dismal failure.

> "In a report issued March 2003, the DOI Inspector General concluded: "We audited the Minerals Management Service's (MMS) audit offices and discovered an organization challenged by both management and control issues... We concluded MMS' systems and safeguards are insufficient, and that some of its audit work did not meet [Government Auditing] Standards" IG Rep. No. 2003-I-0023

One of the reasons for MMS's shoddy audit work – which included fabricating audit documents – was its initiative to replace audits with a new computerized "top down" royalty compliance system.

> "The re-engineered process will shift the focus from auditing on a company basis to evaluating expected royalty values on a property basis...MMS plans to conduct significantly fewer audits under this process ... In fact, at one of our meetings, an MMS Audit Manager clearly stated that he believed MMS would no longer be conducting audits and did not need to be concerned about having an adequate internal quality control system as required by the [Government Auditing] Standards."

Industry actively supported MMS's re-engineering proposal because it would reduce the number of audits. However, at the same time it was telling industry and the inspector general that audits were going to be reduced, it was telling state and tribal delegated audit offices that its "re-engineered" computer system was simply an audit tool that would enhance the overall audit program.

In order to get the re-engineered system turned on by October 2001, MMS redirected its own resources away from audits and to its re-engineering initiative. After reviews, the state and tribal audit offices warned MMS that its new computer system was not going to work; they asked MMS to keep the old system operational, so that they could continue to track historical royalty data. After reviewing the Inspector General's report, STRAC wrote to Senator Bingaman:

> "It now appears this 're-engineered compliance review' would allow MMS to attest that a larger percentage of properties are in compliance without performing audits ... Moreover, as MMS told the IG, MMS envisions that its re-engineered compliance reviews will substantially displace audits, which will reduce the independent reliability of MMS's database even further."

Why would Interior want to reduce the governments' ability to audit oil industry books, considering the long history of industry misreporting and cheating on royalty payments? STRAC also has expressed concern that MMS's initiative is aimed at easing states and tribes out of the royalty management program. State and tribal participation in audits was authorized by Congress in 1982 after congressional findings that Interior was operating the royalty program as an "honor system", under which federal lessees (oil companies) were allowed to report and pay whatever they wanted. An independent commission, whose findings Congress adopted, told Interior to implement independent cross checks of industry representations and to avoid blind acceptance of industry "bookkeeping."

The contractor responsible for the new "re-engineered" computer system is Accenture (formerly Andersen Consulting). Accenture was paid for its work and is now being paid more to try to fix its mistakes. The MMS Contracting Officer involved in awarding Accenture the contract, left MMS in order to go to work for Accenture. In addition to MMS, Accenture's clients include BP, Citgo and Halliburton.

MMS's computer woes do not end with Accenture. One of the computer systems that would feed into the re-engineered computer compliance program is operated by Inovis (formerly Peregrine). Every month companies must pay royalties and file reports (called 2014s), which enable MMS to distribute the collected funds to state and tribal beneficiaries. In the spring of 2002, MMS learned that Inovis had "lost" the company reports. To date, MMS has not resolved this situation, which has delayed distribution of royalties and resulted in substantial interest liability to states, tribes and allottees.[1] Nonetheless, as recently as September 16, 2003, the Interior Department – through the Justice Department – represented to the Court in the Indian Trust Fund case, *Cobell v. Norton*, that the Inovis system "adequately safeguarded" all royalty information.

The Farmington Indian Minerals Office's (FIMO) battles with MMS Headquarters is illustrative of MMS' rush to settlements without audits. The office was opened specifically because the Navajo mineral owners believed the federal government had been mismanaging their resources. The Director of that office, Kevin Gambrell, had ongoing conflicts with MMS because he believed they were regularly underpaying royalties to the Navajos. In 1998, he wrote to MMS Associate Director Lucy Querques Dennett, "As the fiduciary, we are committed to providing excellent service to the beneficiary, but our efforts have been curtailed by the approach taken by MMS..." Mr. Gambrell was able to renegotiate settlements between MMS and the oil industry so that the Navajo's would receive **eight times** more than MMS had determined was owed. According to Mr. Gambrell, MMS had not relied on audits to determine what the oil industry owed the Navajos. In February 2003, Mr. Gambrell began disclosing his concerns to the Court-appointed Special Master overseeing the Indian Trust Fund. In September 2003, MMS fired Mr. Gambrell.

Interestingly, it is the information from these computer systems that must form the basis for MMS's "experience" under the 2000 oil valuation rules discussed above. MMS (even theoretically) conducts audits on a three year schedule. Compliance audits under the 2000 rules would, thus, commence in 2003. While there are a few audits that go through the end of 2000 (and thus cover 7 months under the 2000 oil valuation rules), these were conducted by states and/or tribes.

Royalty-In-Kind "Pilot" Quietly Expanded to Account for over 30% of All Royalties

Further evidence that MMS's ultimate vision is to eliminate checks and balances and professional accounting standards is its extraordinary expansion of the Royalty-In-Kind (RIK) program. The RIK program was promoted by the oil industry during the battle over implementation of the oil valuation rule. Industry preferred RIK as an alternative to paying royalties in cash because it protected federal lessees from having to open their books and records to auditors. Under an RIK program, inexperienced government employees become responsible for marketing the government's royalty share. The royalty share is taken in oil, not in money.

MMS initially labeled its RIK program as a "pilot" program. However, according to the General Accounting Office (GAO), that "pilot" program has ballooned to being used for over 30 percent of the public's royalty share. In January 2003, GAO found that " ... MMS cannot systematically assess whether the Royalty-In-Kind sales are administratively less costly, whether they generate fair market value or at least as much revenue as traditional cash royalty payments, and thus whether MMS should expand or contract the Royalty-In-Kind program." GAO-03-296. Moreover, GAO concluded that MMS had utterly failed to collect "the necessary information to effectively monitor and evaluate the Royalty-In-Kind Program."

Congress directed that MMS demonstrate that its RIK Programs make as much or more money for the public before expanding them further. Such a finding has never been produced by MMS. Despite this, Interior: (1) promoted the employee responsible for managing the RIK program (Walter Cruickshank), who was also given a Presidential award for RIK success; (2) awarded a contract in January 2003 to a company, Lukens Energy Group; one of the principals of which was industry's primary lobbyist for promoting the RIK alternative during the battle over the 2000 oil valuation rules; (3) created a new SES-level position titled "Senior Policy Advisor" to MMS, whose responsibility is to administer RIK operations (Donald Sant); and (4) elevated to an SES position (deputy associate director) to another employee whose prior responsibility was the day-to-day management of MMS's RIK program (Milton Dial). A third SES promotion was given to John Russo, who formerly was in charge of offshore royalty audits, but whose new responsibilities will include RIK.

Despite the GAO's findings, MMS has also cited its RIK "experience" to support its proposal to change the 2000 oil valuation rules. However, it should be underscored that currently MMS is "paying" for most of its RIK costs by using royalty dollars or production. Thus, for example, MMS will reduce the public's royalty share of production taken in kind or in dollars by the costs it incurs to transport or market the production. Because of this, MMS has an incentive to shift more transportation, marketing and other administrative costs to the "deductible from royalty" category, if for no other reason than to make its RIK program "look" revenue neutral.

For all of the above reasons, POGO opposes the proposed amendments to the oil valuation rule.

Sincerely,

(Original on File)

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[1] MMS recently asked the Interior Solicitor to issue an opinion that would limit its exposure to paying interest to the states. Under statute, if states are not paid by a date certain and the payment is delayed because of MMS's failure to account, Interior must pay interest to the States out of its own appropriated budget. It is interesting to compare MMS's effort to escape interest liability to states with its request to Congress to authorize use of appropriated funds to pay for private counsel to Interior officials in the Indian Trust Fund case.